Supreme Court, U.S.
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No. 06-666

In the

Supreme Court of the United States

DEPARTMENT OF REVENUE OF KENTUCKY, ET AL.,

Petitioners,

v.

GEORGE W. DAVIS and CATHERINE V. DAVIS,

Respondents.

On Writ of Certiorari to the Court of Appeals of Kentucky

BRIEF FOR THE STATES OF NORTH CAROLINA, ALABAMA, ALASKA, ARIZONA, ARKANSAS, CALIFORNIA, COLORADO, CONNECTICUT, DELAWARE, FLORIDA, GEORGIA, HAWAII, IDAHO, ILLINOIS, INDIANA, IOWA, KANSAS, LOUISIANA, MAINE, MARYLAND, MASSACHUSETTS, MICHIGAN, MINNESOTA, MISSISSIPPI, MISSOURI, MONTANA, NEBRASKA, NEVADA, NEW HAMPSHIRE, NEW JERSEY, NEW MEXICO, NEW YORK, NORTH DAKOTA, OHIO, OKLAHOMA, OREGON, PENNSYLVANIA, RHODE ISLAND, SOUTH CAROLINA, SOUTH DAKOTA, TENNESSEE, TEXAS, UTAH, VERMONT, VIRGINIA, WASHINGTON, WEST VIRGINIA, WISCONSIN AND WYOMING AS AMICI CURIAE IN SUPPORT OF PETITIONERS

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INTERESTS OF AMICI CURIAE

For nearly a century, States have exempted interest on their own bonds from income taxation while taxing interest income on the bonds of sister States. The overwhelming majority of States have a taxation system comparable to Kentucky's. A decision by this Court proscribing this longstanding practice would injure the States in several distinct and important ways.

The States' sovereign interest in controlling their finances and debt service was recognized as far back as *The Federalist* No. 81, where Alexander Hamilton wrote that the Constitution did not "divest[]" the States "of the privilege of paying their own debts in their own way." *The Federalist* No. 81, at 488 (Alexander Hamilton) (Arlington House 1965). When the Commerce Clause is wrongly construed so as to unduly interfere with the ability of elected state officials to perform traditional state functions, the sovereignty of *all* States is adversely affected.

If the decision of the Kentucky Court of Appeals is affirmed, the 38 States that exempt their own bonds from state income taxation, while taxing the bonds of sister States, will face staggering potential liability. The amount at issue for even a single tax year will significantly impact state budgets. New York estimates that it will face claims of $200 million for past tax years and will lose annual revenue of approximately $70 million should the decision below be affirmed. The liability will be even greater in those States where challenges were filed several years ago. In North Carolina, for example, a class of taxpayers is seeking the refund of all income taxes paid on out-of-state bonds since 2001.

Finally, all States have a substantial interest in this appeal given its potential impact on the overall bond market. An affirmance of the Kentucky Court of Appeals would put the "bond market into an unprecedented upheaval." Timothy P.

Noonan & David Martin, *U.S. Supreme Court's Decision to Hear Municipal Bond Case Raises Constitutional, Procedural Questions*, 44 State Tax Notes 969 (2007). The bond market historically has reacted negatively to change, especially dramatic change. Any instability in the market stands to devalue substantially bonds held by the residents of all 50 States. Additionally, some States could see increases in their costs of borrowing. *See* Dwight Denison, Merl Hackbart & Michael Moody, *Davis v. Department of Revenue: A Preliminary Impact Assessment* 11 (Inst. for Federalism & Intergovernmental Relations Working Papers Series, Paper No. 2007-03, 2006), *available at* http://www.ifigr.org/publication/index.html (follow "No. 2007-03" hyperlink) (stating that elimination of state tax exemption "could have a dramatic impact upon municipal bond yields"). For this reason, all of the Amici States (regardless of their taxation system) have a strong interest in ensuring that the decision below is reversed.

SUMMARY OF ARGUMENT

The practice by States of exempting their own bonds from taxation, while taxing the interest on bonds of other States, is longstanding, widespread and well-known by Congress. This practice serves legitimate and important state interests. States exempt interest on their own bonds from income taxation because it allows them to lower their financing costs, improve their credit ratings and build more schools, hospitals, libraries and roads. Bond purchasers are willing to accept a lower interest rate for a tax-exempt bond than for a comparable taxable bond because they are motivated by the net return on investment (i.e., the income stream produced by the bond less taxes imposed on this income).

Tax exemption of municipal bonds is not without its costs. When a State exempts a bond from taxation, it forgoes a stream

of tax revenue that it would otherwise be entitled to receive over the life of the bond. States do not give up this income stream lightly. Rather, they generally forgo this income stream only when they know that what they are getting in return (more favorable interest rates) will benefit the State. Kentucky, like virtually every other State, exempts only its own bonds from taxation. This ensures that the tax revenue Kentucky is forgoing benefits the building of schools, hospitals, roads and other infrastructure in the State – the same use those taxes would have served had they been collected over the life of the bond. Kentucky's taxation system therefore serves legitimate state interests, unrelated to protectionism.

Kentucky's practice of exempting only Kentucky bonds from state income taxation helps state and local governments fulfill their essential functions; it does not favor private industry. Because this taxation system does not give in-state private industry a competitive advantage over out-of-state interests, it withstands scrutiny under *United Haulers Ass'n v. Oneida-Herkimer Solid Waste Mgmt. Auth.*, 127 S. Ct. 1786, 1790 (2007).

Importantly, Kentucky is not similarly situated to other entities selling bonds in Kentucky. First, no other bond issuer is in the business of providing public works within the State of Kentucky. Second, only Kentucky can forgo collecting income tax upon its bonds and, by doing so, ensure that the tax revenue that Kentucky is forgoing will still serve to facilitate the building of schools, hospitals and roads in Kentucky. Kentucky is therefore unique among other entities selling bonds within Kentucky. The Kentucky Court of Appeals therefore erred in concluding that the Kentucky taxation system violates the dormant Commerce Clause.

The lower court also erred in concluding that Kentucky is not a market participant. When States act as market participants, their actions are free from dormant Commerce Clause analysis. Here, Kentucky is merely agreeing to forgo

collecting a tax in order to obtain more favorable terms for a product that Kentucky itself is selling in the marketplace. Kentucky therefore is a market participant.

If the decision of the Kentucky Court of Appeals is upheld, the impact on States and bondholders will be devastating. Given Congress' implicit approval of this longstanding, widespread and well-known taxation practice, any change should be made by Congress, not the courts.

ARGUMENT

This Court has "long recognized that principles of federalism and comity generally counsel that courts should adopt a hands-off approach with respect to state tax administration." *Nat'l Private Truck Council v. Okla. Tax Comm'n*, 515 U.S. 582, 586 (1995); *see also Wisconsin v. J.C. Penney Co.*, 311 U.S. 435, 444 (1940) (recognizing that States should be free to pursue their own fiscal and taxing policies). Those principles apply with particular force in this case. For nearly a century, States have exempted from taxation the interest earned on their own bonds, while taxing interest income from the bonds of other States. This practice has been acknowledged and countenanced by Congress and this Court. To suddenly strike it down in the name of the dormant Commerce Clause would be a stark departure from tradition, one with potentially devastating consequences for the States. This Court's Commerce Clause jurisprudence requires no such result.

To the contrary, state laws that favor local government serve legitimate, non-protectionist interests and are therefore consistent with the Commerce Clause, under both the anti-discrimination and market participant lines of cases. This Court has also recognized that congressional acquiescence in longstanding state practices militates in favor of sustaining such practices. Kentucky's tax system should be upheld.

I. A STATE LAW PROVIDING INCOME TAX EXEMPTIONS FOR INTEREST EARNED ON BONDS ISSUED BY THE STATE AND ITS POLITICAL SUBDIVISIONS, BUT NOT INTEREST EARNED ON BONDS ISSUED BY OTHER STATES AND THEIR POLITICAL SUBDIVISIONS, DOES NOT DISCRIMINATE AGAINST INTERSTATE COMMERCE.

In *United Haulers Ass'n v. Oneida-Herkimer Solid Waste Mgmt. Auth.*, 127 S. Ct. 1786, 1795-96 (2007), this Court rejected the charge that a "law[] favoring local government" was facially discriminatory within the meaning of the dormant Commerce Clause and therefore invalid. The Court recognized that the "government is vested with the responsibility of protecting the health, safety, and welfare of its citizens," and that "[t]hese important responsibilities set state and local government apart from typical private business." *Id.* at 1795. The Commerce Clause was not intended to, and has never been understood to, stand in the way of the States directly engaging in those activities – be they processing garbage, running prisons, financing capital improvements or constructing roads.

Laws favoring local government are consistent with the Commerce Clause because local government is not "similarly situated" to potential competitors and because "[l]aws favoring local government . . . may be directed toward any number of legitimate goals unrelated to protectionism." *Id.* at 1796. Courts "should be particularly hesitant to interfere with [a government's] efforts under the guise of the Commerce Clause" where the government is engaged in what "is both typically and traditionally a local government function." *Id.* (citation and quotation marks omitted).

All of these considerations apply with full force in this case and support upholding Kentucky's tax system. When States sell bonds to pay for hospitals, roads, prisons and other

important capital projects – and exempt the interest on those bonds from state income taxes to lower the bonds' effective cost to the State – they are engaging in a traditional government activity that serves core sovereign functions. Out-of-state governmental bond issuers are not similarly situated to the taxing State and its political subdivisions, and legitimate interests are served by the States' common practice of exempting the interest earned on their own bonds from taxation, but not extending that exemption to bonds issued by other States.

A. This Practice Is Longstanding and Widespread.

The practice by States of exempting their own bonds from taxation, while taxing the bonds of sister States, dates back to the beginning of state income tax statutes. *See, e.g.*, 1919 N.Y. Laws 1641-42; 1921 N.C. Sess. Laws 208; 1921 Mass. Acts 616; 1923 N.H. Laws 78; 1926 Va. Acts 961; 1927 S.C. Acts 7; 1929 Ark. Acts 585; 36 Del. Laws 37 (1929); 1936 Ky. Acts 70; *see also* 1901 Hawaii Sess. Laws 31-32 (territorial practice that continued following statehood).

This longstanding practice is grounded in this Court's decision in *Bonaparte v. Tax Court*, 104 U.S. 592 (1881). In *Bonaparte*, this Court held that New York, by exempting its own bonds from taxation, could not compel Maryland to refrain from taxing those bonds when acquired by a Maryland resident. In rendering its decision, this Court declared:

> [I]f a State could protect its securities from taxation everywhere, it might succeed in borrowing money at reduced interest; but, inasmuch as it cannot secure such exemption outside its own jurisdiction, it is compelled to go into the market as a borrower, subject to the same disabilities in this particular as

> individuals. . . . [T]he States are left free to extend the comity which is sought, or not, as they please.

Id. at 595. With this Court's imprimatur, and the longstanding acquiescence of Congress, state legislatures have enacted and enforced taxation systems for a hundred years with the belief that whether a State exempts the bonds of a sister State is an issue of comity that may be "extend[ed], or not, as [States] please." *Id.*

This historical practice by States of only exempting their own bonds from taxation continues today. Virtually all States that have a state income tax exempt their own bonds, but tax the bonds of sister States.[1] As reflected by this nearly universal

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[1] Ala. Code § 40-18-14(3)(f) (2003); Ariz. Rev. Stat. Ann. § 43-1021(3) (Supp. 2006); Ark. Code Ann. § 26.51-404(b)(5) (1997); Cal. Rev. & Tax. Code § 17133 (West 2004); Colo. Rev. Stat. § 39-22-104(3)(b) (2006); Conn. Gen. Stat. Ann. § 12-701(a)(20)(A)(i), (B)(vii) (West Supp. 2007); Del. Code Ann. tit. 30, § 1106(a)(1) (1997); Ga. Code Ann. § 48-7-27(b)(1)(A) (2005); Haw. Rev. Stat. §§ 39-11, 47-13, 235-7(a)(5), (a)(6), (b)(2) (1993); Idaho Code Ann. § 63-3022M(1), -3022M(3)(b) (2007); Kan. Stat. Ann. § 79-32,117(b)(i) (Supp. 2006); Ky. Rev. Stat. Ann. § 141.010(10)(c) (West Supp. 2006); La. Rev. Stat. Ann. §§ 47:48 (2001), 47:293(6)(a), (b) (Supp. 2007); Me. Rev. Stat. Ann. tit. 36, § 5122(1)(A) (Supp. 2006); Md. Code Ann., Tax-Gen. §§ 10-204(b), 10-305(d) (LexisNexis Supp. 2006); Mass. Gen. Laws Ann. ch. 62, § 2(a)(1)(A) (West Supp. 2007); Mich. Comp. Laws Ann. § 206.30(1)(a) (West Supp. 2007); Minn. Stat. Ann. § 290.01(19a)(1)(i) (West 1999); Miss. Code Ann. § 27-7-15(4)(d) (Supp. 2006); Mo. Ann. Stat. § 143.121(2)(b) (West Supp. 2007); Mont. Code Ann. § 15-30-111(1)(a)(i), (2)(a)(i) (2005); Neb. Rev. Stat. § 77-2716(1)(a), (c) (Supp. 2006); N.H. Rev. Stat. Ann. § 77:4(I) (Supp. 2006); N.J. Stat. Ann. § 54A:6-14 (West 2002);

practice and by the submission of this amici brief on behalf of 49 States in support of Kentucky, "the entities which supposedly suffer by discriminatory taxation of municipal bond income – the states themselves – have never challenged the practice[, and] have almost uniformly adopted this method of subsidizing local public works bonds." Scott K. Attaway, Note, *The Case for Constitutional Discrimination in Taxation of Out-of-State Municipal Bonds,* 76 B.U. L. Rev. 737, 767 (1996).

B. The Widespread Practice by States of Exempting Their Own Bonds, While Taxing the Bonds of Sister States, Is Directed Toward Legitimate Goals Unrelated to Protectionism.

1. To understand why States do not extend the tax exemption to bonds issued by other States, it is helpful to understand why States grant the exemption to their own bonds.

N.M. Stat. § 7-2-2(B)(3), (V) (2005); N.Y. Tax Law § 612(b)(1) (McKinney Supp. 2006); N.C. Gen. Stat. § 105-134.6(c)(1) (2007); N.D. Cent. Code § 57-38-01.2(1)(g) (2005); Ohio Rev. Code Ann. § 5747.01(A)(1) (LexisNexis Supp. 2007); Okla. Stat. Ann. tit. 68, §§ 2358 (A)(1), 2358.5A(A) (West Supp. 2007); Or. Rev. Stat. § 316.680(2)(a) (2005); 72 Pa. Stat. Ann. §§ 7302, 7303(a)(6), 9901 (West Supp. 2007); R.I. Gen. Laws § 44-30-12(a), (b)(1) (Supp. 2006); S.C. Code Ann. § 12-6-1120(1) (2000 & Supp. 2006); Tenn. Code Ann. § 67-2-104(e)(1) (Supp. 2006); Vt. Stat. Ann. tit. 32, § 5811(18)(A)(i)(II) (Supp. 2006); Va. Code Ann. § 58.1-322(B)(1) (Supp. 2007); W. Va. Code Ann. § 11-21-12(b)(1)(LexisNexis Supp. 2007); *but see* Ind. Code Ann. § 6-3-1-3.5 (LexisNexis Supp. 2006) (extending the exemption to interest earned on bonds issued by governmental entities outside Indiana).

As an initial matter, bond issuances are essential for States to provide needed services to their residents. Not only do they allow States to undertake necessary capital improvements without having to impose exorbitant taxes, they also allow States to spread the cost of the project over its life. Robert S. Amdursky & Clayton P. Gillette, *Municipal Debt Finance Law: Theory and Practice* § 1.1.3, at 10-11 (1992). Thus, bond issuances ensure that the cost of the State's capital improvements will be distributed fairly among taxpayers over the life of those improvements.

The tax exemption of bonds allows state and local governments to pay lower interest rates compared with rates paid on taxable corporate bonds of equal risk and maturity. *See* Michael J. Graetz & Deborah H. Schenk, *Federal Income Taxation: Principles and Policies* 215-16 (5th ed. 2005). A rational bond purchaser takes into account the total cost of the bond (*i.e.*, the original purchase price less the taxes that will have to be paid on it). *Laura v. Droll,* 187 N.W. 876, 878 (Neb. 1922) ("It is self-evident that an investor is concerned mainly with the net returns upon his investment, and if the state or its municipalities issues a security drawing a certain rate of interest, and at the same time taxes the owner of the security a given rate, his net return is the difference between the amount of taxes paid thereon and the amount of interest received.").

If a bond is exempt from taxation, the potential purchaser will be willing to pay more for the bond (or accept a lower interest rate). Thus, when a State, such as Kentucky, sells a bond in the marketplace, it can either: (1) tax the income from that bond over time or (2) exempt the bond from taxation and thereby obtain a more favorable interest rate. Instead of collecting taxes on its bonds over the terms of the bonds and then remitting these tax payments to the specific projects being financed, Kentucky has effectively reinvested these taxes back

into the projects at the outset by obtaining more favorable interest rates when the bonds are issued.[2]

The tax exemption not only allows States to obtain more favorable financing terms, it also gives States the option of borrowing greater sums without jeopardizing their credit ratings. A State's credit rating directly affects the State's borrowing costs. If a State is unable to maintain an acceptable credit rating, its borrowing costs will become prohibitively high. *See* Robert Lamb & Stephen P. Rappaport, *Municipal Bonds: The Comprehensive Review of Tax Exempt Securities and Public Finance* 52 (1980). By exempting its own bonds from taxation, a State can lower its borrowing cost and, consequently, borrow a greater amount without jeopardizing its credit rating.

All told, the tax exemption of bonds is an indispensable tool in ensuring the States' fiscal needs. States have chosen to exempt their own bonds from taxation because it allows them to lower their borrowing costs and to increase the amount of money available to build schools, hospitals and roads.

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[2] Thus, with each debt-service payment, Kentucky is collecting an implicit tax on Kentucky bonds in lieu of the explicit tax that Kentucky collects on the bonds of other States. *See* Edward Zelinsky, *For Realization: Income Taxation, Sectoral Accretionism, and the Virtue of Attainable Values*, 19 Cardozo L. Rev. 861, 912 (1997) (stating that "the owners of municipal bonds . . . pay an implicit tax in the form of higher purchase prices and lower rates of return"); Edward Yorio, *Equity, Efficiency and the Tax Reform Act of 1986*, 55 Fordham L. Rev. 395, 398 (1987) ("It is generally acknowledged that the rate of return on [tax-exempt] bonds is lower than the rate of return on comparable, fully-taxable investments of equivalent risk. To the extent of the difference between those rates of return, the investor is in effect paying an 'implicit tax.'").

2. Kentucky, like almost every other State in the Union, has concluded that the tax exemption for interest income should not be extended to its sister States' bonds. There are sound and sensible reasons for this decision. When Kentucky exempts its bonds from taxation, it is sacrificing future tax revenues from those bonds so that more money can be invested in Kentucky schools now. If Kentucky were to exempt the bonds of other States from taxation, it would be giving up state income taxes without any corresponding benefit to the construction of public works in Kentucky. Thus, granting a tax exemption to bonds issued by Kentucky and its subdivisions furthers the State's legitimate interests. Granting a tax exemption for out-of-state bonds does not. Kentucky should not be forced to forgo state tax revenues to fund the construction of schools in other States. *See Reeves, Inc. v. Stake*, 447 U.S. 429, 442 (1980) (concluding that dormant Commerce Clause does not preclude a State from "restricting to state residents the enjoyment of state educational institutions, energy generated by a state-run plant, police and fire protection, and agricultural improvement and business development programs"). Although Kentucky has a core sovereign interest in the exercise of its borrowing, spending and taxing powers, Kentucky has no stake in the price of other States' bonds and in the trade-off that other States make between collecting funds sooner rather than later.

This Court has stressed that the Commerce Clause does not "prevent the States from structuring their tax systems to encourage the growth and development of intrastate commerce and industry." *Boston Stock Exch. v. State Tax Comm'n*, 429 U.S. 318, 336 (1977). In fact, it is "a laudatory goal in the design of a tax system to promote investment that will provide jobs and prosperity to the citizens of the taxing State." *Trinova Corp. v. Michigan Dep't of Treasury*, 498 U.S. 358, 385 (1991). Kentucky – and the other 37 States with similar tax systems – are merely seeking to effectuate those objectives.

C. The States' Treatment of Interest Earned on State and Local Bonds Is Not Discriminatory Within the Meaning of the Dormant Commerce Clause.

In *United Haulers*, the Court recognized that "it does not make sense to regard laws favoring local government and laws favoring local private industry with equal skepticism." 127 S. Ct. at 1795. This is because "laws favoring local government" typically further legitimate, non-protectionist interests and because local government is not "similarly situated" to potential competitors. *Id.* States furnish public services to their citizens; no other entity competes with a State to undertake that traditional obligation. All this holds true with respect to States' treatment of interest earned on government bonds.

Kentucky's taxation system helps state and local governments fulfill their essential functions; it does not favor private industry. The system does not give any private industry based in Kentucky a competitive advantage over private industries located out-of-state. The statutes at issue achieve a single and simple purpose – the *State* is allowed to give up future tax revenue to obtain better financing terms on the bonds it issues. These bonds then help finance capital improvements necessary to the well-being of the State's residents. Because Kentucky's taxation system "treat[s] in-state private business interests exactly the same as out-of-state ones," it does not violate the dormant Commerce Clause. *Id.* at 1797.

Moreover, the dormant Commerce Clause is focused on the differential treatment of entities that are substantially similar. "'[A]ny notion of discrimination assumes comparison of substantially similar entities.'" *Id.* at 1795 (quoting *Gen. Motors Corp. v. Tracy*, 519 U.S. 278, 298 (1997)). Because Kentucky is not substantially similar to other bond issuers, Kentucky's practice is not discriminatory.

No other State is in the business of providing public works within the State of Kentucky. Additionally, Kentucky is the only State that can agree to forgo the payment of taxes that would otherwise be due to the Kentucky Treasury and thereby obtain better financing terms for infrastructure to be built in Kentucky. Kentucky stands in the unique position of being both the seller and the tax collector with respect to its bonds. No other State stands in this same position with respect to Kentucky state taxes. Consequently, Kentucky is not similarly situated for Commerce Clause purposes with other issuers selling their bonds in Kentucky.

This is precisely the lesson of *Bonaparte*. The Court recognized that because a State bond issuer "cannot secure such an exemption outside of its own jurisdiction, it is compelled to go into the market as a borrower, subject to the same disabilities in this particular as individuals." 104 U.S. at 595. When another State seeks to sell bonds to Kentucky residents, it does not do so as a sovereign governing those residents. It does so as an economic actor trying to convince Kentucky residents that investing in its bonds would be wiser than investing in, say, IBM stock. The relationship between Kentucky and its residents – in general and specifically with respect to the sale and tax treatment of its bonds – is far different. Kentucky stands in the unique position of being the seller, tax collector and spender with respect to its bonds.

General Motors cements the point. In that case, the Court was faced with a challenge to Ohio's taxation system on natural gas sold within the State. Although Ohio imposed a sales and use tax on natural gas, Ohio excepted regulated public utilities from this tax. The Court held that Ohio's taxation system did not violate the dormant Commerce Clause because regulated public utilities were not similarly situated to other sellers of natural gas. Because regulated public utilities were required to provide gas bundled with other services – such as serving all members of the public without

discrimination, "providing a firm backup supply of gas," and assuring continued service to low-paying customers – the products that they sold differed from the products sold by independent gas marketers. *Gen. Motors Corp.*, 519 U.S. at 297, 303-04. The Court emphasized that these services provided by the utilities "serve[] important interests in health and safety" and that "health and safety considerations [may] be weighed in the process of deciding the threshold question whether the conditions entailing application of the dormant Commerce Clause are present." *Id.* at 306, 307.

So too, here, the entity that is receiving favorable tax treatment is an entity whose mission is furthering the public interest of people in the taxing State. Indeed, it is the one entity that, under our constitutional structure, is charged solely with serving the interests of the citizens of Kentucky. The favorable tax treatment of Kentucky bonds helps in achieving those public interests – just as in *General Motors*. This would not be the case with respect to other private and public bond issuers. For purposes of the Commerce Clause, Kentucky is not similarly situated to other issuers of bonds.

The manner in which Kentucky has chosen to finance state and local government is consistent with an "essential and patently unobjectionable purpose of state government – to serve the citizens of the State." *Reeves*, 447 U.S. at 442. The State does not discriminate against interstate commerce when it chooses not to finance other state governments at the same time.

II. AS A SELLER OF BONDS, KENTUCKY STANDS AS A MARKET PARTICIPANT.

The dormant Commerce Clause does not "limit the ability of the States themselves to operate freely in the free market." *Reeves*, 447 U.S. at 437. Rather, when States act as "market participants," as consumers or vendors, their actions are

exempt from Commerce Clause analysis. *Id.* at 439. It is only when the States act as regulators that Commerce Clause analysis is triggered.

The critical issue in distinguishing between the State as a regulator and as a market participant is whether the provision in question affects private trade and not the State's own trade. As this Court concluded in *White v. Mass. Council of Constr. Employees*, 460 U.S. 204, 218 (1983), whether a State is viewed as a market participant "should turn primarily on whether a particular state action more closely resembles an attempt to impede trade among private parties, or an attempt, analogous to the accustomed right of merchants in the private sector, to govern the State's own economic conduct and to determine the parties with whom it will deal."

A State's issuance of bonds and the tax treatment it accords those bonds is a classic example of a State acting in its role of market participant. When a State sells a bond, it is entering into a contractual agreement to repay a loan over time. The State's covenant with the bond purchaser that it will not tax the bond, in turn, is an essential aspect of that contractual agreement because it directly establishes the net return the bondholder will obtain on his investment. Accordingly, Kentucky's agreement to forgo the collection of state income tax cannot be separated from its status as a seller seeking to obtain the best possible terms for its product in the marketplace. The Kentucky Court of Appeals' decision attempting to separate Kentucky's role as a bond seller from its role in setting the tax status for those bonds should be rejected.

Respondents mistakenly contend that this Court's decision in *New Energy Co. v. Limbach*, 486 U.S. 269 (1988), dictates that Kentucky should not be treated as a market participant. *See* Br. in Opp. 11-13. *New Energy*, however, is not on point. In *New Energy*, Ohio provided favorable tax treatment for purchases of ethanol only if the ethanol was produced in Ohio or in a State that granted similar tax advantages to ethanol

produced in Ohio. As such, Ohio was not acting as a seller or purchaser itself but was instead attempting to provide economic benefit to particular private entities. Here, unlike in *New Energy*, Kentucky's tax treatment of its bonds is an integral part of its sale of its own product. The market participant doctrine thus clearly applies.

III. THE RULE ADOPTED BY THE LOWER COURT WOULD HAVE DEVASTATING EFFECTS ON THE STATES' FISC AND THE BOND MARKET, AND REFLECTS A DECISION BETTER LEFT TO CONGRESS.

If the decision of the Kentucky Court of Appeals is upheld, the impact upon the States' fisc will be devastating. Moreover, such a holding will likely destabilize the bond market. Any change to this longstanding taxation practice is better left to Congress, which has thus far countenanced the practice.

1. If a State's tax system is found to be discriminatory in violation of the dormant Commerce Clause, the State has three options to remedy the violation: (1) refund the additional taxes paid by the taxpayers who suffered an undue burden, (2) retroactively impose higher taxes on those who benefitted by the discrimination or (3) some combination of both. *Fulton Corp. v. Faulkner*, 516 U.S. 325, 346-47 (1996). Although a State could, in theory, correct past discrimination by retroactively imposing a higher tax on the holders of tax-exempt bonds who benefitted by the discrimination, that option is not realistic for most States. First, States would face significant constitutional and political hurdles if they were to attempt to increase retroactively taxes for tax years that are already

closed.[3] Second, numerous States have state constitutional provisions that preclude their legislature from taxing their own State's bonds.[4] Third, many States have statutory provisions that create a covenant between the bondholder and the State in which the State agrees, for the life of the bond, not to tax interest arising from the bond.[5]

Should the decision below be affirmed, most States would therefore be faced with refunding any taxes deemed to be discriminatory. For some States, that liability will go back for seven or more years.[6] New York, which generally allows tax refund claims to be submitted for three years following the filing of the return, estimates that the refund claims it faces total $200 million. Thus, States are looking at collective liability in the billions of dollars should this longstanding state practice be declared unconstitutional.

In addition to being subject to claims totaling billions, States will lose a substantial revenue stream on a going forward basis. State and municipal bonds are frequently issued for

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[3] North Carolina, for example, cannot realistically impose a retroactive tax on all taxpayers who held tax-exempt North Carolina bonds during calendar year 2001 (the first tax year at issue in a pending class action filed against the State).

[4] *See, e.g.*, Ky. Const. § 171; Ohio Const. art. VIII, §§ 2k(D)(4), 2l(E), 2m(D), 2n(E), 2o(G), 2p(E) (interest on state bonds "shall at all times be free from taxation within the state").

[5] *See, e.g.*, Cal. Gov't Code § 99016 (Deering 2007); Ga. Code Ann. § 32-10-49 (2007); Ky. Rev. Stat. Ann. § 58.580 (West Supp. 2006); N.Y. Pub. Auth. Law § 372 (McKinney 2004); Va. Code Ann. § 15.2-5361 (2007).

[6] *See, e.g., Dunn v. State*, 635 S.E.2d 604 (N.C. Ct. App. 2006) (class action seeking refund for tax years 2001 and forward), *disc. review granted*, 361 N.C. 351 (2007).

terms of up to 40 years, depending upon the nature of the project being financed. If a State is contractually obligated to treat previously-issued bonds as tax-exempt, that State may be locked into exempting all bonds (both bonds previously issued by the State and the bonds of its sister States) for the next 40 years. Thus, the existence of outstanding bond issuances may well limit the ability of States to tax prospectively all bonds the same. The only choice for many States may be to exempt all bonds for decades to come. States and local governments will then be forced to raise other taxes substantially to replace this lost revenue.

North Carolina's experience following *Fulton* illustrates the budgetary crises that States will face should the decision below be affirmed. In *Fulton*, this Court concluded that North Carolina's intangibles tax violated the dormant Commerce Clause. 516 U.S. at 346-47. The *Fulton* decision involved a single taxpayer who had challenged the tax. Shortly after the *Fulton* decision, however, a class action was filed by a different litigant on behalf of all taxpayers who had paid the intangibles tax to the State. *See Smith v. State*, 507 S.E.2d 28 (N.C. 1998). In that action, the North Carolina Supreme Court held that all intangible taxes collected by the State of North Carolina from 1991 through 1994 had to be repaid by the State. North Carolina ultimately paid $586 million in settlement of the class action. The combined effect of repaying this sum and losing a significant revenue stream contributed to a state budgetary crisis that required the Governor to declare a state of fiscal emergency. Christopher Kirkpatrick, *Easley Declares Fiscal Emergency*, Durham Herald Sun, Feb. 9, 2001, at A1. Over a decade after the *Fulton* decision, the State of North

Carolina remains in litigation over the emergency measures that were taken to keep the doors of State government open.[7]

2. If the decision of the Kentucky Court of Appeals is upheld, the bond market will also be substantially impacted. *See* Noonan, *supra*, at 969 (noting upheaval that will occur in bond market). Bondholders face a risk of substantial devaluation of their bonds, particularly bonds issued by States with high state income taxes.[8] Individuals who hold such bonds may see the market value of their assets decline. *See* Denison, *supra*, at 10. Moreover, such losses will cause many investors to be less inclined to make future purchases of municipal bonds.

3. Respondents are asking this Court to dramatically alter how the States have taxed bonds for the past hundred years. Such a change is best left in Congress' hands. "The Constitution gives that branch of government [Congress] the power to regulate commerce among the states, and until it acts . . . we should enter the field with extreme caution." *Gen. Motors*, 519 U.S. at 310 (quoting *Northwest Airlines, Inc. v.*

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[7] *See Goldston v. North Carolina*, 637 S.E.2d 876 (N.C. 2006) (challenge to Governor's emergency appropriation from State Highway Trust Fund); *see also Coley v. State*, 631 S.E.2d 121 (N.C. 2006) (challenging mid-year increase of state income taxes); *County of Cabarrus v. Tolson*, 610 S.E.2d 443 (N.C. Ct. App. 2005) (challenging Governor's emergency appropriation of funds originally earmarked for local government).

[8] Although many States will not have the option of retroactively taxing bonds that were originally issued as "tax-exempt" by the State, the remedy that is ultimately implemented in each State must be determined, as an initial matter, by state legislatures and state courts. Until the specific remedy becomes settled for each State, the uncertainty as to whether States may tax all bonds will significantly depress the value of "tax-exempt" bonds.

Minnesota, 322 U.S. 292, 302 (1944) (Black, J., concurring)); *see also Quill Corp. v. North Dakota*, 504 U.S. 298, 318 (1992) (concluding that burden on interstate commerce is "not only [a determination] that Congress may be better qualified to resolve, but also one that Congress has the ultimate power to resolve").

This is especially true where Congress has long been aware of a common state taxing practice and has taken no action to forbid it. As this Court observed more than 125 years ago, "[t]he long continued silence of Congress, with its plenary power, in the presence of . . . [state legislation] is itself an implied ratification and adoption, and is equivalent in its consequences to an express declaration to that effect." *Wilson v. McNamee*, 102 U.S. 572, 575 (1880); *see also Gen. Motors Corp.*, 519 U.S. at 305 (concluding that Congress' failure to alter a longstanding state practice indicates that Congress believes the practice to be "within the realm of what the States may reasonably promote and preserve"). That is exactly the situation here. Although Congress has carefully studied the States' longstanding practice with respect to the exemption of interest earned on government bonds, it has chosen not to alter or ban it.

For example, in 1959, Congress directed both the Committee on the Judiciary of the House of Representatives and the Committee on Finance of the Senate to make a full and complete study of "all matters pertaining to the taxation by the States of income . . . from the conduct of business activities which are . . . a part of interstate commerce." Pub. L. 86-272, § 201, 73 Stat. 555, 556 (1959). The resulting reports of the Special Subcommittee on State Taxation of Interstate Commerce were presented to Congress in 1964 and 1965. The Subcommittee sought to identify "the conflicts between the tax policies of the States and the national policy of assuring the free flow of commerce." Special Subcommittee on State Taxation of Interstate Commerce, Committee on the Judiciary,

House of Representatives, State Taxation of Interstate Commerce, H.R. Rep. No. 88-1480, at iii (1964).

In its report, the Subcommittee detailed the practice by States of exempting their own bonds from taxation, while taxing the bonds of other States. H.R. Rep. No. 88-1480, pt. 2, at 258-59 (1964). The report expressly listed the States that engaged in this practice and those that did not. *Id.* at 259, H.R. Rep. No. 88-1480 app. L at A371-A433 (1964). The report, however, did not identify the taxation of bonds as an area of conflict between State and national policy. The study therefore made no recommendation of change in this area. Rather, the study made the general recommendation that States "should be as free as possible to pursue their own tax policies even though they are at variance with the Federal policy." H.R. Rep. No. 89-952, pt. 6, at 1159 (1965). Congress made no effort to change taxation of state and local bonds after receiving the Subcommittee's report.

On numerous other occasions, Congress has been made aware that most States exempt their own bonds from state taxation while taxing the bonds of other States. *See, e.g.*, H.R. Rep. No. 91-413 (1969), *reprinted in* 1969 U.S.C.C.A.N. 1645, 1825 ("State and local governments generally do not directly tax interest on Federal bonds, but they tax the interest income on bonds issued by other States."); S. Rep. No. 91-552 (1969), *reprinted in* 1969 U.S.C.C.A.N. 2027, 2253 (noting state practice of taxing bonds of other States). Thus, Congress is well aware of, and has carefully studied, this practice. Its failure to act strongly supports the practice's validity under the Commerce Clause.[9]

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[9] Another indication of Congress' at least implicit approval of the practice is its actions with respect to Hawaii. In 1901, the United States territory of Hawaii began exempting its own bonds from taxation while taxing the bonds of the States and other territories.

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The decision of the Kentucky Court of Appeals interferes with a fundamental aspect of state sovereignty – the ability of States to determine the most appropriate means of raising revenue in order to provide for the common good. Principles of state sovereignty counsel that this Court should exercise restraint in restricting the manner in which Kentucky undertakes to sell its bonds. *See Reeves, Inc. v. Stake*, 447 U.S. 429, 438 (1980). Federal solicitude for the States' power to manage their debts goes back to the founding of the Republic. *See, e.g., The Federalist* No. 81 (Alexander Hamilton) (Arlington House 1965); *accord Boston Stock Exch. v. State Tax Comm'n*, 429 U.S. 318, 328 (1977) ("The Commerce Clause does not . . . eclipse the reserved 'power of the States to tax for the support of their own governments.'") (quoting *Gibbons v. Ogden*, 22 U.S. 1, 199 (1824)). Kentucky's legislature should be permitted to determine whether it makes good economic sense for the State to forgo payment of taxes on Kentucky bonds in order to obtain more money now (and better

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1901 Hawaii Sess. Laws 31-32. Although Congress had clear authority to override this practice, it did not do so. *See* U.S. Const. art. IV, § 3, cl. 2; *Nat'l Bank v. County of Yankton*, 101 U.S. 129, 133 (1880). In fact, during the 59 years that Hawaii was a territory of the United States, the tax exempt bonds that Hawaii issued were expressly approved by Congress and the President of the United States. *See, e.g.*, 31 Stat. 161 (1900) (Hawaii Organic Act) (bond issuances to be approved by the President); 66 Stat. 133 (1952) (Congressional approval of Hawaii bond issuance). Moreover, when Hawaii was ultimately admitted into the Union, Congress recognized that Hawaii's territorial laws (which at the time included tax exemption for Hawaii bonds but not other States) "shall continue in force." 73 Stat. 4, 11 (1959).

financing terms) to build schools, hospitals and roads. The dormant Commerce Clause does not require that this choice be taken out of the hands of Kentucky's elected officials.

CONCLUSION

The judgment of the Kentucky Court of Appeals should be reversed.

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